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70's Redux. **Investment Strategist Peter Lucas identifies potential catalysts for inflation and the investment implications.**

I am most comfortable when my view is at odds with that of the consensus. Last year I said that inflation was set to rise (*"Current Opportunities", July 2020*) at a time when the US bond market was saying it was going to fall and would remain below 1.5% for the next ten years. Much has changed in the past eleven months. Economies have bounced back as lockdowns have been eased; equity markets and commodities have continued to surge; and 10-year inflationary expectations have jumped from 1.5% to 2.4%, well above the Fed's long-term target. Indeed, inflation, rather than deflation, has become the obsession of investors. Which leaves me in a bit of a quandary. I am pretty sure that rising/high inflation is in our futures, but with so many now on that bandwagon, is it time to reassess? The short answer is no.

That said, it is quite possible that bond markets will continue to track sideways for a while longer. True to form, bond yields peaked in America just as the rate of inflation started to increase. *Buy the rumour, sell the fact.* A lot of bad news was already in the price and hence bonds were able to shrug off the biggest year-on-year jump in consumer prices since 2008. Furthermore, central bankers have worked hard to persuade us that this inflation is just a transitory inflation problem resulting from short-lived supply bottlenecks, rather than the beginning of a 70's-style inflation.

As tempting as it might be under the circumstances to lean into the inflation consensus and to buy government bonds, I would advise against it. Even if the recent rise in inflation is transitory, this will mean that central banks will be in no hurry to tighten monetary policy. If that turns out to be the case, it will risky assets like equities and commodities that will benefit, rather than government bonds, which are still quite dear by historical standards.

The recent spike in inflation may well prove to be transitory, but I sense that any subsequent dip in inflation will be equally short-lived. *The pause that refreshes.* In the 1960's inflation increased gradually at first before rising sharply in a series of violent waves in the mid- and late-70's. Even if inflation does become a serious problem, it unlikely to emerge overnight.

Talking of the 1970's, I am struck by the parallels between then and now: big fiscal deficits and easy monetary policy, a Cold War (this time with China) and deglobalization. These are all necessary preconditions for a rising inflation environment. But are they sufficient? In the 1970's there were key inflation catalysts in the shape of the OPEC oil embargo and currency devaluations. *History does not repeat, but it rhymes.* It looks like oil and currencies have important roles to play again, but for different reasons.

Governments are now clearly committed to getting us to switch to electric, but their efforts are unlikely to put a significant dent in demand for 'dirty energy' for some time to come. Meanwhile, energy companies, starved of capital by the ESG revolution, are in no position to expand production. The oil price has already recovered substantially in the past year, but the risk is that it squeezes much higher as the global economy recovers.

In the 1970's inflation was fanned by significant currency devaluations, themselves a consequence of diverging economic policies between the US/UK on one side and Germany/Switzerland on the other. Again, we see something similar playing out today. The Fed has historically been more proactive than the ECB (and the Bundesbank before it) because it has a full employment objective as well as a low inflation target. In the past decade, the gap between the two central banks has narrowed as the ECB has shed some of its 'Bundesbank' credentials to defend the integrity of euro and the result has been a generally weaker currency. However, with (a) the Fed now targeting an *average* 2% inflation rate over the medium/long-term and (b) Eurozone governments doing more to address the economic tensions within their region, the gap between the two central banks is widening again. Meanwhile, China is also pursuing a relatively tight/prudent monetary policy at time when many of their Western counterparts are doing anything but. China money supply growth is nearer to multi-decade lows at a time when its US equivalent is off the scale.

In summary, this is an environment in which the US dollar is likely to remain weak and commodity prices will continue to rise. Both are bad news for US inflation. For everyone else it depends on how much their currencies appreciate against the US dollar, thereby offsetting the inflationary impact of higher commodity prices. With the eurozone still afflicted with political sclerosis and internal contradictions, there is only so far that the euro can strengthen before cracks start to reappear in the edifice. It is a different story for China, for whom a stronger yuan is much more of a win-win: it would help them suppress inflation as well as help to rebalance their economy from export-led to a consumption-based economy. The outlook for Asian currencies is therefore somewhat brighter.

To conclude, just as central banks are encouraging us to look through the current inflation problem, I recommend looking through any subsequent deceleration in inflation to what lies beyond, which is a weak dollar (strong euro), rising commodity prices and potentially, a much higher oil price. To repeat what was said earlier in this report, inflation is not going to become a major problem overnight, but this is the beginning of that story, not the end. I would like to roundoff with a repeat of my energy shares recommendation of last year ("Light at the end of the tunnel", November 2020) – despite gains of 50% or more, they continue to look a great way of investing for that scenario.

Peter Lucas

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